Client newsletter

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by Don H. Goode

2012 Year End Tax Planning For Individuals

As 2012 draws to a close, there is still time to reduce your 2012 tax bill and plan ahead for 2013. This letter highlights several potential tax-saving opportunities for you to consider. You should consider meeting with your tax advisor to discuss specific strategies.

Basic Numbers You Need To Know

Because many tax benefits are tied to or limited by adjusted gross income (AGI)—IRA deductions, for example—a key aspect of tax planning is to estimate both your 2012 and 2013 AGI. Also, when considering whether to accelerate or defer income or deductions, you should be aware of the impact this action may have on your AGI and your ability to maximize itemized deductions that are tied to AGI. Your 2011 tax return and your 2012 pay stubs and other income- and deduction-related materials are a good starting point for estimating your AGI.

Another important number is your "tax bracket," i.e., the rate at which your last dollar of income is taxed. The tax rates for 2012 are 10%, 15%, 25%, 28%, 31%, and 35%.

However, for 2013, the tax brackets are scheduled to be 15%, 28%, 31%, 36% and 39.6%. Although tax brackets are indexed for inflation, if your income increases faster than the inflation adjustment, you may be pushed into a higher bracket. If so, your potential benefit from any tax-saving opportunity is increased (as is the cost of overlooking that opportunity).

IRA, Retirement Savings Rules for 2012

Tax-saving opportunities continue for retirement planning due to the availability of Roth IRAs, changes that make regular IRAs more attractive, and other retirement savings incentives.

Traditional IRAs: Individuals who are not active participants in an employer pension plan may make deductible contributions to an IRA. The annual deductible contribution limit for an IRA for 2012 is $5,000. For 2012, a $1,000 "catch-up" contribution is allowed for taxpayers age 50 or older by the close of the taxable year, making the total limit $6,000 for these individuals. Individuals who are active participants in an employer pension plan also may make deductible contributions to an IRA, but their contributions are limited in amount depending on their AGI. For 2012, the AGI phase-out range for deductibility of IRA contributions is between $58,000 and $68,000 of modified AGI for single persons (including heads of households), and between $92,000 and $112,000 of modified AGI for married filing jointly. Above these ranges, no deduction is allowed.

In addition, an individual will not be considered an "active participant" in an employer plan simply because the individual's spouse is an active participant for part of a plan year. Thus, you may be able to take the full deduction for an IRA contribution regardless of whether your spouse is covered by a plan at work, subject to a phase-out if your joint modified AGI is $173,000 to $183,000 for 2012. Above this range, no deduction is allowed.

Spousal IRA: If an individual files a joint return and has less compensation than his or her spouse, the IRA contribution is limited to the lesser of $5,000 for 2012 plus age 50 catch-up contributions, or the total compensation of both spouses reduced by the other spouse's IRA contributions (traditional and Roth).

Roth IRA: This type of IRA permits nondeductible contributions of up to $5,000 a year. Earnings grow tax-free, and distributions are tax-free provided no distributions are made until more than five years after the first contribution and the individual has reached age $59^1/_2$. Distributions may be made earlier on account of the individual's disability or death. The maximum contribution is phased out in 2012 for persons with an AGI above certain amounts: $173,000 to $183,000 for married filing jointly, and $110,000 to $125,000 for single taxpayers (including heads of households); and between $0 and $10,000 for married filing separately who lived with the spouse during the year.

Roth IRA Conversion Rule: Funds in a traditional IRA (including SEPs and SIMPLE IRAs), §401(a) qualified retirement plan, §403(b) tax-sheltered annuity or §457 government plan may be rolled over into a Roth IRA. Such a rollover, however, is treated as a taxable event, and you will pay tax on the amount converted. No penalties will apply if all the requirements for such a transfer are satisfied.

In past years, a taxpayer's AGI (whether married filing jointly or single) was limited to $100,000 to make such a conversion and the taxpayer must not be a married individual filing a separate return. The AGI limitation does not apply to conversions from a Roth designated account in a §401 or §403(b) plan. For 2012, the $100,000 income limit on Roth IRA conversions does not apply, and taxpayers will be able to make Roth IRA conversions without regard to their AGI. If you convert to a Roth IRA in 2012, the tax on the converted amount will have to be paid in the year of conversion. Also, if you already made a conversion earlier this year, you have the option of undoing the conversion. This is a useful strategy if the investments have gone down in value so that if you were to do the conversion now, your taxes would be lower.

In addition, for 2012, if your §401(k) plan, §403(b) plan, or governmental §457(b) plan has a qualified designated Roth contribution program, a distribution to an employee (or a surviving spouse) from such account under the plan that is not a designated Roth account is permitted to be rolled over into a designated Roth account under the plan for the individual.

401(k) Contribution: The §401(k) elective deferral limit is $17,000 for 2012. If your §401(k) plan has been amended to allow for catch-up contributions for 2011 and you will be 50 years old by December 31, 2011, you may contribute an additional $5,500 to your §401(k) account, for a total maximum contribution of $22,500 ($17,000 in regular contributions plus $5,500 in catch-up contributions).

SIMPLE Plan Contribution: SIMPLE plan deferral limit is $11,500 for 2012. If your SIMPLE plan has been amended to allow for catch-up contributions for 2012 and you will be 50 years old by December 31, 2012, you may contribute an additional $2,500.

Catch-Up Contributions for Other Plans: If you will be 50 years old by December 31, 2012, you may contribute an additional $5,500 to your §403(b) plan, SEP or eligible §457 government plan.

Required Minimum Distributions: For 2012, taxpayers must take their required minimum distribution from IRAs or defined contribution plans (§401(k) plans, §403(a) and (b) annuity plans, and §457(b) plans that are maintained by a governmental employer).

Maximize Retirement Savings: In many cases, employers will require you to set your 2013 retirement contribution levels before January 2013. If you did not elect the maximum 401(k) contribution for 2012, you can increase your amount for the remainder of 2012 to lower your AGI in order to take advantage of some of the tax breaks described above. In addition, maximizing your contribution is generally a good tax-saving move.

Deferring Income to 2013

If you expect your AGI to be higher in 2012 than in 2013, or if you anticipate being in the same or a higher tax bracket in 2012, you may benefit by deferring income into 2013. Deferring income will be advantageous so long as the deferral does not bump your income to the next bracket.

Deferring income could be disadvantageous, however, if your deferred income is subject to §409A, thus making the income includible in gross income and subject to additional tax. Some ways to defer income include:

Delay Billing: If you are self-employed and on the cash-basis, delay year-end billing to clients so that payments will not be received until 2013.

Fiscal Cliff: Before you consider deferring any income to 2013, you must consider the possibility that tax hikes scheduled to occur in 2013 will actually occur. While it is likely that Congress will negotiate a compromise and not all of the scheduled tax hikes will occur, a substantial number could still occur. Assuming all the scheduled tax increases occur, the Tax Policy Center has estimated the following average tax increases by income group:

Lowest Fifth (average income $11,239) - $412

Second Lowest Fifth (average income $29,204) - $1,231

Middle Fifth (average income $49,842) - $1,984

Second Highest Fifth (average income $80,080) - $3,540

Highest Fifth (average income $178,020) - $14,173

Top 1% (average income $1.3M) - $120,537

Interest and Dividends: Interest income earned on Treasury securities and bank certificates of deposit with maturities of one year or less is not includible in income until received. To defer interest income, consider buying short-term bonds or certificates that will not mature until next year. If you have control as to when dividends are paid, arrange to have them paid to you after the end of the year.

Accelerating Income into 2012

In limited circumstances, you may benefit by accelerating income into 2012. For example, you may anticipate being in a higher tax bracket in 2013, or perhaps you will need additional income in order to take advantage of an offsetting deduction or credit that will not be available to you in future tax years. Note, however, that accelerating income into 2012 will be disadvantageous if you expect to be in the same or lower tax bracket for 2013.

If accelerating income will be beneficial, here are some ways to accomplish this:

Accelerate Collection of Accounts Receivable: If you are self-employed and report income and expenses on a cash basis, issue bills and attempt collection before the end of 2012. Also see if some of your clients or customers might be willing to pay for January 2013 goods or services in advance. Any income received using these steps will shift income from 2013 to 2012.

Year-End Bonuses: If your employer generally pays year-end bonuses after the end of the current year, ask to have your bonus paid to you before the beginning of 2013.

Retirement Plan Distributions: If you are over age $59^1/_2$ and you participate in an employer retirement plan or have an IRA, consider making any taxable withdrawals before 2013.

You may also want to consider making a Roth IRA rollover distribution, as discussed above.

Deduction Planning

Deduction timing is also an important element of year-end tax planning. Deduction planning is complex, however, due to factors such as AGI levels, AMT, and filing status. If you are a cash-method taxpayer, remember to keep the following in mind:

Deduction in Year Paid: An expense is only deductible in the year in which it is actually paid. Under this rule, if your tax rate is going to increase in 2013, it is a smart strategy to postpone deductions until 2013.

Payment by Check: Date checks before the end of the year and mail them before January 1, 2013.

Promise to Pay: A promise to pay or providing a note does not permit you to deduct the expense. But you can take a deduction if you pay with money borrowed from a third party. Hence, if you pay by credit card in 2012, you can take the deduction even though you won't pay your credit card bill until 2013.

AGI Limits: For 2012, the overall limitation on itemized deductions is terminated. In addition, certain deductions may be claimed only if they exceed a percentage of AGI: 7.5% for medical expenses, 2% for miscellaneous itemized deductions, and 10% for casualty losses. However, for 2013, the overall limitation on itemized deductions is scheduled to be reinstated making deductions more valuable in 2012. However, too many itemized deductions in 2012 could trigger AMT. Also, for 2013, medical expenses may be deducted only if they exceed 10% of AGI (7.5% for taxpayers age 65).

Standard Deduction Planning: Deduction planning is also affected by the standard deduction. For 2012 returns, the standard deduction is $11,900 for married taxpayers filing jointly, $5,950 for single taxpayers, $8,700 for heads of households, and $5,950 for married taxpayers filing separately.

As you can see from the numbers, for 2012, the standard deduction for married taxpayers is twice the amount as that for single taxpayers. For 2013, the standard deduction for married taxpayers is scheduled to be less than 200% of the standard deduction for single taxpayers. If your itemized deductions are relatively constant and are close to the standard deduction amount, you will obtain little or no benefit from itemizing your deductions each year. But simply taking the standard deduction each year means you lose the benefit of your itemized deductions. To maximize the benefits of both the standard deduction and itemized deductions, consider adjusting the timing of your deductible expenses so that they are higher in one year and lower in the following year. You can do this by paying in 2012 deductible expenses, such as mortgage interest due in January 2013.

Medical Expenses: Medical expenses, including amounts paid as health insurance premiums, are deductible only to the extent that they exceed 7.5% of AGI. With the percentage scheduled to increase to 10% in 2013 (but staying at 7.5% for taxpayers age 65), it would be wise to consider accelerating medical expenses into 2012, especially if your AGI is lower.

State Taxes: If you anticipate a state income tax liability for 2012 and plan to make an estimated payment most likely due in January, consider making the payment before the end of 2012. However, too high a payment could lead towards being subject to the AMT.

Charitable Contributions: Consider making your charitable contributions at the end of the year.

This will give you use of the money during the year and simultaneously permit you to claim a deduction for that year. You can

use a credit card to charge donations in 2012 even though you will not pay the bill until 2013. A mere pledge to make a donation is not deductible, however, unless it is paid by the end of the year. Note, however, for claimed donations of cars, boats and airplanes of more than $500, the amount available as a deduction will significantly depend on what the charity does with the donated property, not just the fair market value of the donated property. If the organization sells the property without any significant intervening use or material improvement to the property, the amount of the charitable contribution deduction cannot exceed the gross proceeds received from the sale.

To avoid capital gains, you may want to consider giving appreciated property to charity.

Regarding charitable contributions please remember the following rules: (1) no deduction is allowed for charitable contributions of clothing and household items if such items are not in good used condition or better; (2) the IRS may deny a deduction for any item with minimal monetary value; and (3) the restrictions in (1) and (2) do not apply to the contribution of any single clothing or household item for which a deduction of $500 or more is claimed if the taxpayer includes a qualified appraisal with his or her return. Charitable contributions of money, regardless of the amount, will be denied a deduction, unless the donor maintains a cancelled check, bank record, or receipt from the donee organization showing the name of the donee organization, and the date and amount of the contribution.

A special provision that gave taxpayers the ability to distribute tax-free to charity up to $100,000 from a traditional or Roth IRA maintained for an individual whose has reached age $70^1/_2$ expired at the end of 2011. However, Congress may decide to extend this provision retroactively for 2012 before the end of the year.

Education and Child Tax Benefits

Credit for Adoption Expenses: For 2012, the adoption credit limitation is $12,650 of aggregate expenditures for each child, except that the credit for an adoption of a child with special needs is deemed to be $12,650 regardless of the amount of expenses. The credit ratably phases out for taxpayers whose income is between $189,710 and $229,710. While for 2011, the credit was refundable, for 2012, unless Congress acts before the end of the year to change it, the credit is nonrefundable. In addition, beginning in 2013, the adoption credit will only be available for adoption of special needs children with a reduced dollar amount. If you plan on adopting a non-special needs child, you should consider adopting the child in 2012 because there is no guarantee that this law will change in 2013.

Student Loan Interest: You may be eligible for an above-the-line deduction for student loan interest paid on any "qualified education loan." The maximum deduction is $2,500. The deduction for 2012 is phased out at a modified AGI level between $125,000 and $155,000 for joint filers, and between $60,000 and $75,000 for individual taxpayers. However, in 2013, the AGI amounts are scheduled to go down to $40,000 and $55,000 for individual taxpayers, and $60,000 and $75,000 for joint filers with a slight increase for inflation. Another significant change scheduled for 2013 is the reinstatement of the 60-month rule for student loans. That rule provides that interest is only deductible on the first 60-months that interest payments are required. Any loans outstanding for more than 60-months will lose this deduction.

Kiddie Tax: For 2012, the kiddie tax applies to: (1) children under 18; (2) 18-year old children who have unearned income in excess of the threshold amount, do not file a joint return and who have earned income, if any, that does not exceed one-half of the amount of the child's support; and (3) children between the ages of 19 and 23 and if, in addition to the above rules, they are full-time students. For 2012, the kiddie tax threshold amount is $1,900.

Investment Planning

The following rules apply for most capital assets in 2012:

• Capital gains on property held one year or less are taxed at an individual's ordinary income tax rate.

• Capital gains on property held for more than one year are taxed at a maximum rate of 15% (0% if an individual is in the 10% or 15% marginal tax bracket).

Note that Congress has yet to extend the reduced capital gains rates beyond 2012. If not changed, the maximum capital gains rate in 2013 will be 20% (10% for taxpayers in the 15% bracket). In addition, beginning in 2013, a 3.8% tax is levied on certain unearned income. The tax is levied on the lesser of net investment income or the amount by which modified AGI exceeds certain dollar amounts ($250,000 for joint returns and $200,000 for individuals). Investment income is: (1) gross income from interest, dividends, annuities, royalties, and rents (other than from a trade or business); (2) other gross income from any business to which the tax applies; and (3) net gain attributable to property other than property attributable to an active trade or business. Investment income does not include distributions from a qualified retirement plan or amounts subject to self-employment tax. This rule applies mostly to passive businesses and the trading in financial instruments or commodities. With this additional tax, the maximum net capital gains rate could be as high as 23.8% in 2013. Because distributions from qualified retirement plans are not subject to the tax, taxpayers may want to invest in retirement accounts, if possible, rather than taxable accounts.

Timing of Sales: You may want to time the sale of assets so as to have offsetting capital losses and gains. Capital losses may be fully deducted against capital gains and also may offset up to $3,000 of ordinary income ($1,500 for married filing separately). In general, when you take losses, you must first match your long-term losses against your long-term gains, and short-term losses against short-term gains. If there are any remaining losses, you may use them to offset any remaining long-term or short-term gains, or up to $3,000 (or $1,500) of ordinary income. When and whether to recognize such losses should be analyzed in light of the possible future changes in the capital gains rates applicable to your specific investments.

Dividends: Qualifying dividends received in 2012 are subject to rates similar to the capital gains rates. Therefore, qualifying dividends are taxed at a maximum rate of 15%. Qualifying dividends include dividends received from domestic and certain foreign corporations. Note that if Congress does not extend the reduced dividend rates, in 2013, dividends will be taxed at ordinary income rates, which could reach 39.6% (43.4% with the additional 3.8% tax on certain unearned income).

Selling Your (Underwater) Home: If you are currently underwater on your home and you are considering selling or getting a loan modification, you absolutely should get this done in 2012. In 2012, qualified mortgage debt relief from you lender is not considered income. However, if Congress fails to extend this tax benefit, any debt discharged on or after January 1, 2013, will be considered income and taxes will be owed on the amount forgiven.

Selling Your (Inherited) Home: If you received the residence you are using as your principal residence from a decedent who died in 2010 and whose executor elected not to have the estate tax apply, you can include the decedent's use and ownership of the home to qualify for the §121 exclusion amounts. If by the end of 2012, you would meet the 2 of 5 year tests with this tacking, it could be a perfect time to sell and exclude up to $250,000 of gain ($500,000 if married and both spouses received the property).

Social Security: Depending on the recipient's modified AGI and the amount of Social Security benefits, a percentage — up to 85% — of Social Security benefits may be taxed. To reduce that percentage, it may be beneficial to defer receipt of other retirement income. One way to do so is to elect to receive a

lump sum distribution from a retirement plan and to rollover that distribution into an IRA.

Alternatively, it may be beneficial to accelerate income so as to reduce the percentage of your Social Security taxed in 2013 and later years.

Other Tax Planning Opportunities: We also can discuss the potential benefits to you or your family members of other planning options available for 2012, including §529 qualified tuition programs.

Alternative Minimum Tax

For 2012, the alternative minimum tax exemption amounts are currently scheduled to be much lower that will most likely subject more taxpayers to the AMT. The exemption amounts in place for 2012 are: (1) $45,000 for married individuals filing jointly and for surviving spouses; (2) $33,750 for unmarried individuals other than surviving spouses; and (3) $22,500 for married individuals filing a separate return. Also, for 2012, unless Congress acts to extend the previous years' rules, nonrefundable personal credits cannot offset an individual's regular and alternative minimum tax, and capital gains will not be taxed at lower favorable rates for AMT.

Some of the standard year-end planning ideas will not reduce tax liability if you are subject to the alternative minimum tax (AMT) because different rules apply. Because of the complexity of the AMT, it would be wise for you to analyze your AMT exposure.

If you have any questions, please do not hesitate to call. While we are getting very close to the end of the year, there is still time to implement strategies to minimize your 2012 tax liability.

Business Opportunities Group

James H. Neeld, IV
jneeld@youngwilliams.com
(601) 360-9021

Sean Wesley Ellis
wellis@youngwilliams.com
(601) 360-9026

Kenneth D. Farmer
kfarmer@youngwilliams.com
(601) 360-9052

John Wesley Daughdrill, Jr.
wes.daughdrill@youngwilliams.com
(601) 360-9030

Don H. Goode
dgoode@youngwilliams.com
(601) 360-9041

J. Andrew Payne
apayne@youngwilliams.com
(601) 360-9028

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